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ECONOMIC OUTLOOK

Chamber of Commerce of the United States

Fourth Quarter 1992

"TO EVERYTHING THERE IS A SEASON"

The economy has not fit the typical post-recession stereotype over the past year. In fact, the recession lasted from the third quarter of 1990 to the first quarter of 1991 as evidenced by declines in real Gross Domestic Product. Thereafter, the economy grew each quarter, but at less than stellar rates. The economy has grown by only an annualized rate of 1.8 percent since the recession ended. However, real GDP in the third quarter of 1992 has finally gotten back to and exceeded its pre-recession peak. Statistically speaking, the recovery is complete. Unfortunately, there is no season of prosperity in sight.

Dissecting the fall from expansion into recession with traditional business cycle approaches does not get to the heart of the matter. As we have stated before, the end of expansion and the onset of recession were a result of policy mistakes. The 1986 Tax Reform Act raised the cost of capital and greatly harmed the value of assets, particularly commercial real estate. This was followed in 1988 by Fed high interest rate policy designed to slow the economy by restricting credit growth. Compounding these anti-growth measures were substantial increases in federally mandated costs in the form of economically ruinous increases in regulation beginning in 1989. Environmental and workplace regulations have accelerated. Regulation of banks have stifled lending. Finally, federal spending has increased dramatically so that spending as a percent of GDP has risen to near 25 percent. It goes without saying that all of that spending must be financed with revenues and borrowing. With the economy barely growing, new sources of revenue have not been forthcoming. By taking 25 percent of the economy, the federal government is imposing a large burden on the private sector thereby dampening actual and potential GDP growth.

The problem is that these multiple anti-growth policies remain in place. Even the Fed's numerous interest rate cuts do not yet reflect a change from the goals of high interest rate policy. The Fed rate cuts have not led credit market rate reductions, but have merely followed interest rates down. The Fed still fears a credit explosion that will eventually raise inflation. Of course, the economy is otherwise so weak, interest rate cuts have had no lasting effect. Banks, awash in new reserves, have used these funds to buy government debt in an effort to meet harsh regulatory requirements on capital and to shed their balance sheets of potentially troublesome loans.

There is great frustration by adherents to cycle theory and Keynesian models of interest rate sensitivity over the lack of response by the economy to Fed policy and with slow economic growth. Historically, the highest growth is experienced during the recovery phase which lasts from one to two years. A vigorous recovery tends to set the stage for a sizeable expansion. Typically, after the recovery, the economy settles into the expansion phase. In a true expansion, the economy grows at rates sufficient to gradually bring it up to its potential output level, but it does not grow as fast as the period of recovery. That is why the current recovery is scary. If the recovery is too slow, a true expansion will not emerge. Expansions can be fragile if burdened with the wrong federal policies. And fragile expansions are seldom sustainable.

Cycle wonks have overlooked certain pieces of historical evidence. It appears that the duration and strength of the eventual expansion is closely connected with growth during the "pre-recession" phase. The pre-recession phase is a period at the tail end of an expansion characterized by a decline in economic growth. It can be quite short. The last pre-recession phase started in the second quarter of 1989 and lasted five quarters. The economy grew by an annualized rate of 1.3 percent.

In all previous recoveries, the economy grew by more than it grew in the prior pre-recession phase but not by more than twice the pre-recession rate of growth. At 1.8 percent growth, a "normal" recovery is clearly underway. If historical relationships hold, the upper limit on the current recovery is 2.6 percent annualized growth.

Economic Outlook, published quarterly by the Forecasting Section, Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year.

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Dr. Lawrence A. Hunter, Vice President & Chief Economist
Dr. William K. MacReynolds, Director, Economic Policy Center
Susan C. Hammann, Economic Policy Research Assistant

UNITED STATES ECONOMIC OUTLOOK 1992-1993

Prepared by the U.S. Chamber of Commerce

Fourth Quarter 1992

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS							YEARS				
	Actual		Forecast					Actual			Forecast	
								Annual Average				
	92/2	92/3	92/4	93/1	93/2	93/3	93/4	'83-'88	1990	1991	1992	1993
GROSS DOMESTIC PRODUCT												
Nominal GDP	4.3	4.5	4.7	5.6	5.0	4.9	4.8	7.5	5.2	2.8	4.6	5.0
Real GDP	1.5	2.7	2.9	2.7	1.7	1.3	0.8	4.0	0.8	-1.2	1.9	2.2
Consumption	-0.1	3.4	3.0	2.2	-0.9	1.0	0.9	4.1	1.2	-0.6	2.1	1.5
Residential Investment	12.6	0.4	4.8	6.6	4.5	4.8	5.6	10.8	-9.1	-12.6	11.9	5.2
Nonresidential Investment	16.1	0.3	5.1	5.9	14.9	4.9	10.6	4.8	-0.4	-7.0	2.3	7.7
Equipment	24.1	8.5	7.4	8.1	23.7	6.9	13.6	8.5	-1.0	-4.6	6.9	12.5
Structure	-0.8	-17.7	-0.9	0.0	-9.3	-1.1	1.5	-2.6	0.9	-12.0	-7.6	-4.4
Real Net Exports (87$B)	-43.9	-51.5	-54.3	-51.6	-52.1	-49.1	-48.4	-88.7	-51.8	-21.8	-42.8	-50.3
Exports	-1.4	1.9	4.0	5.6	4.6	5.4	4.4	6.7	8.1	5.8	5.0	4.2
Imports	14.7	6.9	5.5	3.4	4.5	3.1	3.6	10.5	3.0	-0.1	8.6	5.1
Government Purchases	-1.2	2.0	0.9	2.9	1.5	2.4	-1.7	3.2	2.8	1.2	-0.3	1.5
Change in Business Inventories (87$B)	7.8	14.7	17.4	12.1	15.8	6.0	-5.8	21.6	6.2	-9.3	6.8	7.0
Final Sales of Domestic Product	-0.1	2.1	2.7	3.1	1.4	2.1	1.7	3.8	1.3	-0.8	1.6	2.2
EMPLOYMENT, PRODUCTION, PROFITS, INTEREST RATES, INCOME AND PRICES												
Civilian Unemployment Rate (%)	7.5	7.6	7.6	7.5	7.4	7.5	7.6	7.2	5.5	6.8	7.5	7.5
Industrial Production	5.2	1.6	2.0	3.0	1.1	2.9	1.0	4.9	1.0	-1.9	1.0	2.3
New Car Sales (mill.)	8.4	8.2	8.6	8.9	9.0	8.8	8.9	10.5	9.5	8.4	8.3	8.9
Domestic Car Sales (mill.)	6.2	6.0	6.4	6.7	6.8	6.6	6.7	7.6	6.9	6.1	6.1	6.7
New Housing Starts (mill.)	1.14	1.20	1.27	1.28	1.31	1.35	1.39	1.68	1.20	1.01	1.22	1.33
Compensation	2.6	3.7	3.8	4.2	4.4	3.9	3.8	4.3	5.4	4.7	3.6	4.0
Productivity	2.0	3.6	2.1	2.7	1.5	1.4	1.1	1.9	0.0	0.1	2.7	2.2
Unit Labor Costs	0.6	0.1	1.7	1.5	2.9	2.5	2.7	2.3	5.4	4.5	0.9	1.8
Consumer Price Index	2.6	2.6	3.2	3.2	4.1	3.8	3.4	3.5	5.4	4.3	3.1	3.4
Implicit GDP Deflator	2.7	1.9	1.8	2.9	3.3	3.4	3.8	3.3	4.3	4.0	2.6	2.8
Prime Interest Rate (%)	6.5	6.0	6.0	6.0	6.0	6.0	6.0	9.8	10.1	8.5	6.2	6.0
3-month Treasury Bill Rate (%)	3.7	3.2	3.0	3.1	3.3	3.6	3.4	7.8	7.5	5.4	3.5	3.4
Corporate Bond Rate (%)	8.3	8.1	8.0	7.9	7.8	7.7	7.8	10.7	9.3	8.8	8.2	7.8
Real Personal Disposable Income	1.2	0.0	1.6	2.6	2.0	1.5	1.0	3.6	0.9	-0.2	1.9	1.7
Changes in Profits from Current Production ($B)[1]	4.4	3.4[2]	2.1	-3.2	1.0	5.0	2.1	29.8	-1.1	-15.4	43.2	4.9

[1] Corporate profits with inventory valuation and capital consumption allowances.

[2] USCOC estimate.

FORECAST ASSUMPTIONS

This forecast table contains advance estimates of the National Income and Product Accounts for the fourth quarter of 1992. The nation's money supply M(2) is assumed to grow by 2.0 percent in 1992 and 3.5 percent in 1993. The trade weighted exchange value of the dollar falls by 2.8 percent in 1992 and falls by 1.8 percent in 1993.

SOURCE: U.S. Chamber of Commerce, Forecast Section.

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Expectations of greater than this amount were misplaced.

We project that when industrial production, employment and housing starts are more firmly on the way back to pre-recession peak levels in the first quarter of 1993, after a very slow and uneven start, the economy will have grown by 2.5 percent over its last four quarters of growth. What is troublesome about this forecast from a cycle analysis standpoint, is that whatever expansion that follows is destined to be slow. Instead of catching up, the economy will diverge more from its postwar trend level of output creating a large and expanding "growth gap." Therefore, a true expansion is not in the cards.

Moreover, expansions at less than 2 percent lasting for periods of up to a year historically are not sustainable. In fact, by traditional definitions, they are not expansions at all. Instead they are more correctly classified as periods of pre-recession leading almost without fail to recession.

In the near term, the economy grew by 2.7 percent in the third quarter of this year and will grow between 2.5 percent and 3.0 percent during the next two quarters. Both the fourth quarter of 1992 and the first quarter of 1993 will be bolstered by expenditures made to rebuild hurricane stricken areas of Florida and Louisiana. Beginning with the second quarter of 1993, the economy will again grow persistently by less than 2.0 percent. Unless there are pro-growth federal policies enacted that reduce regulations, curtail federal spending growth and cut taxes there is a distinct possibility of recession in 1994.

There are few pro-growth policies that enjoy political support. Among presidential and congressional candidates there is significant support for indexing capital gains. The idea is that taxes should be paid only on real gains and that like individual income taxes, inflationary gains should be removed from the basis of taxation. If all assets are indexed for inflation then inflation adjustment would apply to assets that depreciate as well so that companies that invest in plant and equipment are able to recover the full replacement cost of their investment.

Indexing capital gains and depreciation deductions would be the economic equivalent of providing an 80 percent exclusion for capital gains and a permanent, universal 5 percent investment tax credit. Even economists who favor taxing ordinary income and capital gains at the same rate agree that inflation should not be taxed. It is unjust and economically damaging.

Consider a small investor who invested $1,000 in the Standard and Poor's 500 Index in 1970 and sold his stock for $3,677 in late 1990. He would have realized a taxable capital gain of $2,677. At a 28 percent tax rate, the taxpayer would have owed $750 in tax. But inflation between 1970 and 1990 was more than 218 percent, so the taxpayer's real gain was only $257. He was taxed $750 on a real gain of $257, an outrageous tax rate of 292 percent that left him worse off than if he had never sold the stock. No wonder millions of people have "locked-in" hundreds of billions of dollars in assets and refuse to sell their stocks, farms, businesses and houses. We estimate that indexing capital gains for inflation would "unlock" an additional $800 billion in assets in the first year it is enacted.

The reduction in the cost of capital produced by indexing capital gains and depreciation deductions would immediately make economically viable ventures that were uneconomical at the higher cost of capital, which means more new businesses and more jobs. In a study conducted for the U.S. Chamber of Commerce by Fiscal Associates Inc., former Treasury economists Gary and Aldonna Robbins estimate that indexing capital gains for inflation would:

- Increase U.S. capital formation by $1.6 trillion by 1996 and by $2.7 trillion at the end of the decade.
- Create an extra 542,000 jobs by 1996 and 938,000 by the year 2000.
- Add $473 billion to GDP by 1996 and $1.6 trillion by the end of the decade.

The good news gets even better. Fiscal Associates estimates that indexing depreciation deductions would:

- Increase U.S. capital formation by $3.0 trillion by 1996 and by $4.8 trillion at the end of the decade.
- Create an extra 931,000 jobs by 1996 and 1.7 million by the year 2000.
- Add $804 billion to GDP by 1996 and by $2.8 trillion by the end of the decade.

These figures track closely what happened from 1983 through 1989 when the supply of capital was increased by $700 billion as a direct consequence of tax law changes made in 1981 and 1982. The reduction in the cost of capital brought about by indexing would be about four times that produced in the 1981 and 1982 tax law changes. Cheaper capital in the U.S. means more jobs stay at home. And more jobs mean more GDP.

The combined economic effect of indexing the cost basis of assets is dramatic. The cost of capital would come down by some 20 percent, which in turn would increase the nation's average annual economic growth rate during the next six years from the consensus forecast of 2.4 percent to 3.4 percent, a rate we enjoyed during the last six years of the 1980s.

Is this a tax cut for the rich? No! Indexing capital assets would constitute broad-based tax relief for small investors, small businesses, workers, farmers and the elderly. It would virtually eliminate capital gains taxes for the average taxpayers earning below $100,000. Consider a typical middle-income taxpayer who bought a home for $125,000 in 1975 when he was 45. Since 1975, average home prices have increased 184 percent, most of which is due to inflation. So the house is worth $355,000 today. If the taxpayer, now 62, wants to sell his home to

retire or reinvest his money to produce income, he would realize a capital gain of $230,000. If he uses his one-time exclusion of $125,000, his taxable capital gain is $105,000 and he owes $29,400 in capital gains taxes. If the purchase price of his house were indexed for inflation, as fairness would dictate, his basis would equal $300,000 after accounting for the 140 percent inflation since 1975, and he would owe the government nothing because his $55,000 capital gain would be less than the exclusion.

Few myths are as enduring as the myth that only the rich benefit from capital gains. In this example, the sale of our moderate-income individual's house (a non-recurring capital gain) made him look rich that one year. A more realistic picture of his economic situation is portrayed by using "ordinary income." In 1987, the latest year for which data are available, more than 70 percent of those reporting capital gains had ordinary income of less than $50,000.

Even those people who don't sell property gain by indexation. The stock market likely would appreciate by 20 percent as a direct consequence of indexing capital gains and depreciation deductions. The market appreciation would strengthen the pension systems of private companies and the pension funds of public employees. Indexing capital gains and depreciation would yield enormous dividends, for example, to the 16 million moderately paid state and local government employees who have a $852 billion stake in state and municipal pension funds.

The loudest objection to indexing will be a misplaced concern that it will increase the deficit. It will not. Indexing will lessen the cost of the S & L bailout by about 20 percent, or approximately $100 billion, because the asset values of the RTC will increase and fetch more revenue when they are eventually sold. The revenue-loss issue at best is a red herring, at worst an outright distortion. Even those most fearful of lost revenue admit that in the short run (three to four years), indexing capital gains and the unlocking of assets it generates will produce substantial increases in federal and state revenues. The study done for the Chamber estimates that, during the first four years, the unlocking effect of indexing alone would generate $20 billion in new capital gains revenues for the federal government, offsetting an estimated $20 billion static loss in federal revenues resulting from indexing depreciation. So, even under the overly cautious static revenue estimating assumptions (i.e, that indexing will not generate new economic growth), the four-year revenue effect is a wash.

When increased economic growth is taken into account, the Chamber study estimates that the combined indexation of capital gains and depreciation actually would yield a five-year revenue increase to the federal government of $176.5 billion. State and local governments can expect a simultaneous revenue increase of approximately $134.6 billion.

Even if indexing gives no boost to economic growth, the unlocking of assets would yield the federal government on net slightly more than $10 billion in additional revenues in the first two years and about $8.5 billion more to state and local governments, investors get a tax cut and the tax system would be fairer. Four out of five ain't bad, especially since no one argues that indexing capital gains and depreciation will produce any short-run economic harm.

Critics contend, however, that indexing capital gains and depreciation will lose revenue over the long run. We disagree. If our growth projections prove accurate, the long-term increase in revenues from an improved economy will more than offset any revenue loss caused by changing the way tax is computed. By the year 2000, for example, the Chamber study estimates that federal revenues would actually be $71.6 billion higher with indexing in place. But what if we are wrong about the long-run effects? What are the consequences?

The critics would have us believe the consequences are dire — that indexing eventually would produce huge revenue losses and bankrupt the nation. That isn't true. Indexing does not set in motion some unalterable chain of events. If we are wrong and revenues decline over the long run as a result of indexing, Congress could take action to remedy the situation by reducing spending growth or raising other taxes. Since nearly every economist agrees that inflation indexing is the correct economic treatment of capital gains and depreciation, Congress would probably want to raise taxes in a more economically sensible manner if it determined in the future that a tax increase were necessary. And finally, if indexing were done via regulation, one would hope it would prompt Congress to give serious consideration to other changes to the tax code to improve economic growth.

The only logical explanation for opposition to capital asset indexation is an inordinate fear of change. Policy paralysis like this represents a collective neurosis that is unwarranted by the facts. It simply makes no sense for Americans to endure unfair and economically damaging tax policy because of a trepidation that Congress might prove incapable of taking responsible action in the future. After all, one does not refrain from motoring west from New York simply because he would fall into the Pacific Ocean if he failed to alter his heading at some later point.

"To everything there is a season." In 1990, Congress and the President thought it was the season to raise taxes. Since then, it has been the season of economic stagnation. Now is the season for reducing taxes. A few years from now, it may be the season for raising taxes again. We won't know until we get there. One thing we know for sure: It would be foolish to forego the certain benefits of indexing capital gains today because of anxiety that such a policy might have drawbacks several years from now — especially when the potential problems are so directly amenable to immediate congressional remedy if they develop.

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ECONOMIC
OUTLOOK

Chamber of Commerce of the United States — First Quarter 1993

WHAT WILL CLINTON DO?

As the new year begins and as a new administration prepares to govern, there is a fierce struggle for the economic heart and soul of president-elect Bill Clinton. The first major battle is over doing something about the deficit or helping the economy grow. Advisors, politicians and analysts pushing deficit reduction do so in hopes of eventually turning the economy around by raising national savings. The opposing view has it that improving investment incentives will generate more jobs and higher economic growth beginning at once. They argue that this approach will help state and local governments and eventually bring the budget deficit down because of increased federal revenue growth. Some of those in the latter group point out that George Bush chose to attack the budget deficit regardless of the impact on the economy and lost his reelection bid. It remains to be seen which view will dominate the policy making of the new president.

One talked-about policy idea, a short-term fiscal stimulus, has lost some of its luster as the economy has shown signs of renewed health. The economy picked up in the last half of 1992 to over 3 percent annualized growth. This comes after five quarters that had averaged only about 1.5 percent average annual growth since the recession ended in early 1991. Post recession growth has been spurred by increased consumption spending. If this were a normal, sustainable recovery, all signs would be pointing upward and the need for stimulus would be quite small. Unfortunately, this is anything but a normal, robust recovery. The causes of slow growth, the recession and the anemic recovery — severe policy mistakes — have yet to be reversed.

The economy is doing better now primarily because of temporary factors that will soon wear off. First, decreased income tax withholding, starting in January 1992, increased take home pay throughout last year. Households were able to pay down debt and increase spending. In effect, there has already been a middle class tax cut in 1992 that is paying dividends. Unfortunately, by April 15, 1993 the bill will come due. The decreased withholding will result in lower-than-normal tax refunds and higher-than-normal tax payments. Consequently, consumers will have less spending power than is usual in early 1993. Because normal seasonal adjustment factors will anticipate increased consumption, restrained take-home pay will lead to an abnormally low level of consumption in the second quarter. A smaller than normal rise in consumer spending will translate into a drop in seasonally adjusted consumer spending during the second quarter of 1993.

Secondly, in the aftermath of hurricanes Andrew and Iniki, there has been a surge in household spending on many items such as furniture and appliances which were damaged or destroyed. This surge will peter out in early 1993 returning consumer spending growth on many durable and nondurable goods to less lofty rates. Thus, consumer spending in the first half of 1993 will not be as strong a stimulus to growth as that which occurred during the last half of 1992. Moreover, because the surge in consumer spending in late 1992 may become part of the seasonal adjustment pattern, normal amounts of consumer spending growth during the last half of this year will be translated into sub-normal amounts of growth.

Thirdly, higher income people and many businesses expect their taxes to be raised in 1993. Consequently, there has been an effort to accelerate reported income into 1992 and divert expenses into 1993. This brings into question whether the reported increases in income in late 1992 and better tax receipts by some state and local governments are sustainable in 1993. These are key factors contributing to our forecast of slowing economic growth by the second quarter of 1993 unless policy changes are made to generate more economic activity.

Without policy improvements, the economy is likely to return to rates of growth more consistent with its longer-run potential under the current policy regime — in the neighborhood of 2 percent. Since the passage of the 1986 Tax Reform Act, incentives to invest, work and produce have diminished. The primary problem, recognized by almost all economists, has been a reduction in the return to investment or, in other words, a rise in the cost of capital. The primary culprits are less equitable depreciation allowances, increased capital gains taxes and the alternative minimum tax. The 1986 Act lengthened depreciation lives for most assets, especially structures. It is no coincidence that since 1987, commercial property values have diminished in major economic areas of the U.S. This has been a primary contributor to bank and thrift failures, bankruptcies, a small business credit crunch and a depression in the construction industry. The Federal Reserve has also contributed by allowing the slowest growth in the money aggregates in three decades resulting in an actual decline in real M2 money supply.

The depreciation problem can be seen in depressed asset "recovery" rates, a term that should not to be confused with economic

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Nominal GDP	4.3	5.3	5.2	5.6	5.0	4.9	4.8	7.5	5.2	2.8	4.7	5.2
Real GDP	1.5	3.4	3.2	2.7	1.6	1.8	1.9	4.0	0.8	-1.2	2.0	2.5
Consumption	-0.1	3.7	3.0	2.5	-0.9	2.6	1.5	4.1	1.2	-0.6	2.1	1.9
Residential Investment	12.6	0.2	4.8	6.6	4.5	4.8	5.6	10.8	-9.1	-12.6	11.9	5.2
Nonresidential Investment	16.1	3.1	7.7	5.9	14.9	4.9	4.0	4.8	-0.4	-7.0	2.9	8.1
Equipment	24.1	9.5	11.4	8.0	23.4	6.8	5.2	8.5	-1.0	-4.6	7.3	12.8
Structure	-0.8	-11.3	-2.0	0.3	-8.4	-0.8	0.4	-2.6	0.9	-12.0	-6.8	-3.5
Real Net Exports (87$B)	-43.9	-52.7	-51.6	-54.3	-54.8	-51.8	-55.2	-88.7	-51.8	-21.8	-42.4	-54.0
Exports	-1.4	9.2	6.8	4.3	4.6	5.4	3.6	6.7	8.1	5.8	6.2	5.2
Imports	14.7	14.8	5.5	5.7	4.5	3.1	5.4	10.5	3.0	-0.1	9.6	6.8
Government Purchases	-1.2	3.8	1.8	1.5	1.5	2.4	-1.7	3.2	2.8	1.2	-0.1	1.5
Change in Business Inventories (87$B)	7.8	15.0	11.9	14.0	16.3	-0.8	9.5	21.6	6.2	-9.3	5.5	9.8
Final Sales of Domestic Product	-0.1	2.8	3.5	2.5	1.4	3.2	1.1	3.8	1.3	-0.8	1.7	2.4
EMPLOYMENT, PRODUCTION, PROFITS, INTEREST RATES, INCOME AND PRICES												
Civilian Unemployment Rate (%)	7.5	7.6	7.3	7.3	7.4	7.4	7.5	7.2	5.5	6.8	7.4	7.4
Industrial Production	5.2	2.1	2.8	3.0	1.1	2.9	1.0	4.9	1.0	-1.9	1.1	2.5
New Car Sales (mill.)	8.4	8.2	8.6	8.9	9.0	8.8	8.9	10.5	9.5	8.4	8.3	8.9
Domestic Car Sales (mill.)	6.2	6.0	6.4	6.7	6.8	6.6	6.7	7.6	6.9	6.1	6.1	6.7
New Housing Starts (mill.)	1.14	1.20	1.25	1.28	1.31	1.35	1.39	1.68	1.20	1.01	1.21	1.33
Compensation	2.4	3.5	3.8	4.2	4.4	3.9	3.8	4.3	5.4	4.7	3.6	4.0
Productivity	1.7	3.0	2.9	2.7	1.5	1.4	1.1	1.9	0.0	0.1	2.7	2.2
Unit Labor Costs	0.8	0.6	0.9	1.5	2.9	2.5	2.7	2.3	5.4	4.5	0.9	1.8
Consumer Price Index	3.5	2.6	3.2	3.2	3.9	3.8	3.4	3.5	5.4	4.3	3.1	3.4
Implicit GDP Deflator	2.7	2.0	2.0	2.9	3.6	3.1	2.9	3.3	4.3	4.0	2.6	2.8
Prime Interest Rate (%)	6.5	6.0	6.0	6.0	6.0	6.0	6.0	9.8	10.1	8.5	6.2	6.0
3-month Treasury Bill Rate (%)	3.7	3.2	3.1	3.3	3.3	3.2	3.1	7.8	7.5	5.4	3.5	3.2
Corporate Bond Rate (%)	8.3	8.1	8.0	8.1	8.0	8.0	8.0	10.7	9.3	8.8	8.2	8.0
Real Personal Disposable Income	1.2	0.5	1.6	2.6	2.0	1.5	1.0	3.6	0.9	-0.2	2.0	1.7
Changes in Profits from Current Production ($B)[1]	4.4	-14.3	15.6	-3.2	1.0	5.0	2.1	29.8	-1.1	-15.4	37.7	6.2

[1] Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains final estimates of the National Income and Product Accounts for the third quarter of 1992. The nation's money supply M(2) is assumed to grow by 3.5 percent in 1993. The trade weighted exchange value of the dollar is projected to rise by 1.0 percent in 1993.

SOURCE: U.S. Chamber of Commerce, Forecast Section.

recovery from recession. The asset recovery rate measures how much of an asset's replacement value (a calculation based on historical costs, inflation and alternative rate of return) can be recovered or written off under current tax laws. At present, shorter-term assets have a top recovery rate of 88 percent while longer-term assets can have as low as a 50 percent recovery rate. This is the main reason why longer-term investment has fallen in recent years — the incentive to invest longer-term has been greatly diminished. With low recovery rates, the pre-tax rate of return to longer-term investments would have to be extremely high to justify the investment in question.

As a matter of fairness, recovery ought to be 100 percent for all assets. This would reflect the fact that investment is a normal cost of doing business and should be fully deductible. Congress finds it difficult to adopt expensing of assets because it would greatly reduce federal revenues in the first few years even though it would raise economic growth and, hence, revenue growth over the longer-term. Under current law, Congress must find "offsets," such as other tax increases — which partially or wholly defeat the purpose of any tax decrease in the first place. Congress could suspend current law to increase the near-term budget deficit for the sake of increasing economic growth, but is loath to do so. Although the law does not allow immediate expensing of investment expenditures, tax law could be written to avoid less than 100 percent recovery, to avoid a bias against longer-term investments and to keep the deficit from rising in the near-term.

The alternative to expensing is neutral cost recovery — the present value equivalent of expensing. Neutral cost recovery schemes generally keep existing asset depreciation lives intact, but adjust depreciation for inflation and the rate of return in alternative investments or, simply, the time value of money. Interestingly, one neutral cost recovery proposal generates increased revenue in the first few years while generating almost the same impact on economic growth as expensing or other neutral cost recovery schemes. The goal is the same as expensing — bring recovery rates to 100 percent to increase the incentive to invest and remove the bias against longer-term investment.

If neutral cost recovery is not politically acceptable, indexing assets for inflation would be a great improvement over the present system. Indexing would have a powerful impact on the economy. Indexing assets obtains about 60 percent of the economic growth benefits of expensing. In effect, indexing raises the amount of depreciation by the inflation rate and would raise recovery rates significantly. Indexing would be the equivalent of a permanent, universal 5 percent investment tax credit. It is a plan to increase long-term economic growth. But if indexing is started right away, it would also have an immediate impact on the economy. Of course, inflation indexing would also apply to asset sales for capital gains purposes, as well as asset purchases for investment. If indexed for inflation, capital gains taxes would be treated the same as taxation of ordinary income — a fundamental goal of the 1986 Act — which is indexed.

Inflation indexing for capital gains has the benefit of lowering the effective capital gains rate. Indexing is equivalent to an 80 percent exclusion of taxable capital gains. Like any tax cut on assets, indexing would encourage an "unlocking" of asset holdings by making economic the sale of assets that have accrued inflationary gains. Under current law, taxing inflationary gains makes the sale of these assets uneconomic because the amount of tax is so high. The unlocking effect would generate at least an additional $1 trillion in asset sales. When sold, the revenue collected from these assets sales would generate enough additional federal revenue to offset lost revenue from indexing for depreciation purposes. Not only would indexing directly reduce the cost of capital, it would generate capital mobility. The capital gains tax has been called a tax on opportunity. Retrospective indexing would create greater capital mobility immediately. Capital would be available to go into new investment opportunities soon after indexing becomes law.

The election of Bill Clinton has placed the focus on an investment tax credit (ITC) which works indirectly on depreciation through tax laws to raise the recovery rate. However, to the extent the ITC is temporary, targeted and incremental, its impact on the economy will be limited to shorter-term stimulus leaving longer-term incentives to invest unchanged. An ITC would improve the outlook for 1993. A permanent, universal ITC would do double duty. It would raise real GDP growth in 1993 and in later years as well.

Yet, investment incentives can be severely hampered if the alternative minimum tax (AMT) law is not reformed significantly or abolished. Under current law, even the best ITC would not be available for use by most corporations because of AMT. The alternative minimum tax is, in essence, a separate tax system requiring some companies to calculate depreciation in as many as 19 different ways. The purpose of AMT was to close loopholes for companies that perennially experienced positive cash flow profits, but did not have tax liability. The recession, unfortunately, has put many corporations under AMT — an unintended result that has greatly stifled investment spending since an AMT corporation can recover very little of its investment expenses. Paradoxically, tax law has put many companies that have invested heavily and have created jobs during the recession under AMT thereby discouraging future investment and growth.

Correcting investment incentives would be a major step in augmenting economic performance. But poor investment incentives are just part of the story. Since the 1981 tax cuts which spurred investment and economic growth, taxes at all levels of government have increased many times. Except for the tax act in 1982 which reversed some of the 1981 cuts and the 1990 Budget Act which raised federal taxes by $160 billion over five years, the other separate tax increases were each of a small amount. However, over time the combined effect of the numerous small tax increases is quite large. In 1993, a combination of various federal tax increases will amount to at least $13 billion. It has been estimated that state and local governments facing budget crises will increase 1993 taxes by almost $17 billion. The combined federal, state and local tax increase, roughly $30 billion is not an insignificant amount. Since Congress plans to offset any tax cuts they enact in 1993 with additional tax increases, the economy could be facing upwards of $50 billion of tax increases in 1993. All economic models must take these actions into consideration when gauging the impact of tax cuts to spur investment and federal spending increases on investment.

Congress must be careful to fund new investment spending on infrastructure with cuts from planned spending increases on consumption. Otherwise, the private sector will be burdened with financing a higher federal deficit over the longer-term. It is probably not possible to put a lasting lid on federal consumption expenditures such as most entitlements, transfer programs and subsidies at this time. Congress can set temporary caps, but at the same time it must set up various commissions on spending, divided by spending category, to recommend a permanent program of spending restraint later in 1993.

There is no trick to balancing the federal budget. Projections by the Congressional Budget Office (CBO) reveal that to balance the budget in the year 2002 requires an average annual rate of spending

growth of 3.0 percent. This is almost as large as the projected rate of inflation over that time. It is slightly higher than the projected rate of economic growth, 2.5 percent average annual growth rate.

Spending growth will almost surely be double the 3.0 percent rate in 1993. CBO projects that long-term spending will grow by at least 5.5 percent rate through the year 2002. This is less than the rate of growth in spending from 1980 through 1992. However, the economy grew faster with greater inflation during that time than is projected for the next ten years. As a result, CBO still projects a deficit of over $400 billion by the year 2002. Clearly, further spending restraint is necessary to ease the burden on the private economy to finance government growth. The key step to reducing future deficits is to enact tough spending prioritization plans to take spending increases away from consumption and put it toward investment. Enhanced private investment incentives can then perform a second, important task: The higher economic growth that incentives help generate will raise federal revenue growth. This will allow the federal government to close the deficit sooner or to keep spending growth above 3.0 percent for ten years and still balance the budget by the year 2002.

A final factor affecting the economy is the compliance cost of new regulations. These mandated costs on the private economy, although difficult to measure, will more than likely exceed the amount of new taxes in 1993. Estimates of additional compliance cost from the Clean Air Act, the Americans with Disabilities Act, new banking law and other major legislation range from $40 billion to $70 billion in 1993 alone. Purchases of equipment to help the environment may amount to almost $20 billion. Congress should allow these mandated purchases to be expensed. One wild card is what will happen when the regulatory moratorium is lifted on January 20, 1993. A whole slew of new regulations held back by the moratorium of 1992 could hit the economy in the last half of 1993. Mr. Clinton seems to recognize that new banking regulation is stopping the economic recovery from accelerating by prolonging the small business credit crunch. He may recommend changes that allow bankers to take prudent risks once again.

Many aspects of the economy are looking much better. Consumer and business confidence levels have risen since the November election. Employment and industrial production are picking up, albeit at a slow pace. New orders received by manufacturers have increased in recent months. Exports have continued to increase even though some major industrialized countries are experiencing recession. Other aspects of the economy have stopped falling as much or have leveled off. Business failures and bankruptcies are rising, but only slightly. Debt delinquencies are holding steady. Business lending by banks has stopped falling.

So far what is lacking is a vision. The question that should be asked is, "what is needed to bring the economy back up to its postwar trend amount last reached in early 1989?" Since then, a widening gap has emerged between actual GDP and its trend amount. To close this gap, the economy would have to grow at an annual rate of 4 percent for six years or so. Therefore, setting a goal of 4 percent growth is reasonable and, based on past experience, doable without igniting new bouts of inflation.

Blue Chip forecasters expect growth of just 2.8 percent in 1993 and an average of 2.5 percent annually for ten years thereafter. If taken seriously, these projections sound the loudest alarm. Postwar economic growth averaged over 3 percent. The consensus near-term and long-term forecasts suggest that the growth gap will widen further if nothing is done to close it. Thus, there is a great deal of room for improvement in both the short-term and the long-term performance of the economy. Unfortunately, a low rate of return to investment under current federal policies will likely keep long-term growth closer to 2 percent than 2.5 percent. Over ten years, this half percentage point difference translates in a loss of over $500 billion in output. Improving the chances for stronger economic growth through new, permanent incentives to invest should be the primary concern of the new administration.

In presenting his initial economic plans, the new president is likely to adopt rhetoric that promises to meet key economic and policy goals, namely, the promise of more jobs and a lower deficit. There are objective, analytical ways to measure whether or not these promises can be kept. If, on the one hand, taxes are raised now with the promise of future spending restraint then, based upon past experience, the economy will not pick up much, if any, new growth. Moreover, the deficit will most surely widen from near-term spending increases and because promises to cut future spending never seem to materialize. Indeed, Congress usually spends more than it manages to raise through tax hikes. Estimates vary, but researchers have shown that spending tends to rise by $1.57 or more every time Congress raises taxes by $1. Witness the past two years. Although the 1990 Omnibus Budget Reform Act promised over $300 billion in spending cuts between 1991 and 1995, the spending baseline has actually risen. This occurred even though the tax increases have evaporated. If, on the other hand, the numbers show tax cuts to spur economic growth and, at the same time, Congress cuts future spending, then history suggests there is a good chance that this policy will succeed both to accelerate growth in the economy and lower the federal deficit.

In any administration divided over stimulus and deficit reduction, political power lies with the number crunchers at the Office of Management and Budget (OMB). Eschewing analytical rigor, past administrations have produced a budget that simultaneously raises revenues from tax hikes and from new economic growth. Such political projections allowed past Congresses and administrations to increase the spending baseline to make room for any new promised spending initiatives without seriously cutting existing spending programs. Miraculously, these past budget-makers managed to project reduced future deficits.

Instead of trying to wade through the rhetoric and the fanciful projections, observers needed to look only at the new spending baseline. If it was higher than previous baselines for both near-term and longer-term spending, this meant that the government would grow relative to the private economy and would, therefore, be unable to reduce the deficit. If they directly raised taxes (remember OMB always overestimates the revenue flow from tax hikes) in an effort to be responsible, they never got the enhanced economic growth promised and the deficit got larger.

The history of the 1970s and 1980s shows that Congress prefers increased spending financed by higher levels of revenue and deficits. On rare occasions, Congress will pass tax cuts to spur investment, but its leaders will then complain the government is starved for revenue. They will complain the loudest when they are under pressure, legal or political, to reduce deficit spending they voted for in the first place. This is a natural course of events given the political incentives of holding office. The response is not to launch an ideological battle with Congress, but to propose solutions that work. The new president has an excellent opportunity to do just that and, in the process, gain permanent political support for his program of change.

ECONOMIC OUTLOOK

A3840-6

Chamber of Commerce of the United States — Second Quarter 1993

IS ECONOMIC GROWTH SUSTAINABLE?

Indicative of its manic-depressive behavior of the last four years, the economy failed to sustain the improvement registered in the second half of last year. After growing at better than a 4 percent rate in the final two quarters of 1992, the real economy faltered badly in the first quarter of this year, expanding an anemic 0.9 percent. The slowdown was widespread and occurred despite a significant buildup in inventories. While most forecasters project some improvement in the second half of the year, the economy will be hard pressed to achieve a 2.5 percent growth rate for the year as a whole. Such paltry growth questions the sustainability of the expansion and may leave the economy vulnerable in 1994, when the fiscal drag of deficit reduction is anticipated to hit.

Recent Experience

The latest revision to real GDP lowered the growth rate almost a full percentage point from the previous estimate. Although the revision was due almost entirely to a single factor, namely the net export component, both the current and former reports indicated a broad based slowdown from the pace of late last year.

Consumption expenditures rose only 1.2 percent during the first quarter, as purchases of both durable and nondurable goods faltered. Residential construction was flat following a surge of activity late last year, and government purchases dropped sharply in the wake of the defense build-down. Net exports plummeted as weak growth among our major trading partners sapped export demand at the same time that imports surged.

The flagging consumption growth led to a ballooning in inventories that more than accounted for the entire growth in output. This inventory bulge will contribute to slower economic growth in subsequent quarters as the accumulation is worked off. If there was one bright spot in the report, it was the continued improvement in purchases of equipment, primarily computers.

The report also revealed a disconcerting increase in inflation. The GDP price deflator rose 3.3 percent in the first quarter after rising only 2.6 percent during 1992. Fortunately, this increase appears to reflect transitory factors, such as weather, rather than to indicate a permanent acceleration in inflation. The first quarter report on productivity and costs showed an increase in unit-labor-costs, but the increase was only 1.4 percent on an annual basis. Another measure of wage inflation, the employment cost index, rose 1.0 percent in the first quarter -- about the same rate as the latter part of last year.

While the first quarter's economic picture was quite sobering, there were a number of extenuating circumstances that may have contributed to the extent of the slowdown and should reverse themselves over the next few quarters. Poor weather over much of the first quarter delayed housing construction, kept consumers bottled up at home, and boosted prices of perishable food items. Reduced withholding during 1992 boosted consumption last year, but led to "return shock" when income tax forms were filed in early 1993. Defense related expenditures, which are adjusting unevenly to a changing military environment, dropped sharply in the first quarter, but should stabilize over the remainder of the fiscal year. Finally, consumer confidence which rose sharply in the wake of the presidential elections returned to reality as the new Administration has exhibited adjustment problems.

While the early reports on economic activity in April are mixed, they indicate a modest improvement over the first quarter. Employment in April rose as the economy added 119,000 jobs. The improvement, however, was confined to the service sector as manufacturing jobs continued to decline. The economy as a whole is still about one million jobs short of its pre-recession peak.

The average workweek rose slightly, as did average weekly earnings, and it appears that managers still prefer to use the existing work force more intensely rather than hiring new workers.

Retail sales in April rose sharply on the strength of auto sales, and both housing sales and starts showed renewed signs of life as well. However, new orders for manufactured durable goods, the industrial production index and capacity utilization were virtually flat.

Economic Outlook, published quarterly by the Chamber of Commerce of the United States of America, provides its readership with the Chamber's official forecast of the U.S. economy. It analyzes the vital issues affecting current economic activity and provides the latest economic trends. Subscription cost is $60.00 per year.
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Dr. Martin A. Regalia, Vice President & Chief Economist
Mr. Martin Lefkowitz, Director, Special Projects
Ms. Susan C. Hammann, Economic Policy Research Assistant

UNITED STATES ECONOMIC OUTLOOK 1993

Prepared by the U.S. Chamber of Commerce

Second Quarter 1993

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated.)

	QUARTERLY							ANNUALLY			
	Actual		Forecast					Actual		Forecast	
	92/4	93/1	93/2	93/3	93/4	94/1	94/2	1991	1992	1993	1994
GROSS DOMESTIC PRODUCT											
Nominal GDP	7.1	4.4	4.8	5.5	5.9	6.0	5.6	2.8	4.8	5.4	5.7
Real GDP	4.7	0.9	2.0	2.8	3.1	3.0	2.5	-1.2	2.1	2.6	2.7
Consumption	5.1	1.2	2.9	3.2	3.3	3.0	2.7	-0.6	2.3	2.9	2.9
Residential Investment	25.1	-0.2	9.1	15.0	13.5	7.7	4.0	-12.6	13.1	9.7	8.6
Nonresidential Investment	9.7	11.4	10.3	8.6	8.8	8.1	7.7	-7.0	3.0	9.7	8.0
Equipment	14.5	15.6	14.9	13.1	14.6	10.8	10.5	-4.6	7.5	15.2	11.6
Structures	-1.9	-1.7	-2.7	-4.7	-8.9	-0.5	-1.5	-12.0	-6.8	-3.9	-2.9
Real Net Exports (87$B)	-49.0	-71.1	-70.3	-75.9	-82.9	-87.9	-91.7	-21.8	-41.8	-75.1	-90.6
Exports	8.9	-2.6	5.0	3.3	3.0	3.0	3.2	5.8	6.3	3.5	3.2
Imports	5.7	12.0	4.0	6.3	6.8	5.6	5.0	-0.1	9.6	8.7	5.2
Government Purchases	-2.6	7.3	4.0	0.0	-1.5	0.5	1.5	1.2	-0.3	-1.3	0.7
Change in Business Inventories (87$B)	10.3	39.0	11.0	4.8	6.4	6.6	1.9	-9.3	12.2	15.3	-1.0
Final Sales of Domestic Product	5.2	-1.2	4.1	3.3	3.0	3.0	2.9	-0.8	1.7	2.5	3.0
EMPLOYMENT, PRODUCTION, PROFITS, INTEREST RATES, INCOME AND PRICES											
Civilian Unemployment Rate (%)	7.3	7.0	7.0	6.9	6.9	6.8	6.8	6.8	7.4	7.0	6.8
Industrial Production	4.4	5.2	3.3	4.2	4.3	4.0	3.9	-1.9	1.2	4.2	4.0
New Car Sales (mill.)	8.2	8.3	8.7	8.9	9.1	9.2	9.3	8.2	8.2	8.8	9.2
Domestic Car Sales (mill.)	6.4	6.3	6.6	6.8	6.9	7.0	7.0	6.1	6.3	6.7	6.9
New Housing Starts (mill.)	1.24	1.16	1.25	1.36	1.38	1.40	1.38	1.01	1.21	1.29	1.38
Compensation	4.3	3.3	3.5	3.5	3.6	3.9	3.9	4.7	3.7	2.8	3.8
Productivity	4.1	-0.1	1.9	1.3	1.6	1.9	2.0	0.1	2.7	1.9	1.8
Unit Labor Costs	0.3	3.4	1.6	2.2	2.0	2.0	1.9	4.5	0.9	1.8	2.0
Consumer Price Index	3.2	3.6	3.0	3.1	3.0	3.2	3.0	4.3	3.1	3.0	3.1
Implicit GDP Deflator	2.3	3.3	2.7	2.7	2.9	2.9	3.0	4.0	2.6	2.7	2.9
Prime Interest Rate (%)	6.0	6.0	6.0	6.0	6.0	6.0	6.0	8.5	6.3	6.0	6.0
3-month Treasury Bill Rate (%)	3.1	3.0	2.9	3.0	3.0	3.1	3.0	5.4	3.5	3.0	3.0
Corporate Bond Rate (%)	8.0	7.8	7.6	7.5	7.5	7.3	7.3	8.8	8.1	7.6	7.3
Real Personal Disposable Income	4.2	2.7	2.4	2.7	2.6	2.6	2.6	-0.2	2.2	2.6	2.6
Changes in Profits from Current Production ($B)[1]	54.4	4.0	25.0	20.0	10.0	15.0	6.0	-4.25	47.4	70.0	50.8

[1] Corporate profits with inventory valuation and capital consumption allowances.

Both retail and wholesale prices jumped noticeably in April, continuing the run-up since the beginning of the year. These increases have panicked financial market participants and triggered a modest increase in longer-term interest rates. The recent price behavior is not consistent with the considerable slack that remains in the labor markets and plant capacity and, thus, should unwind over the remainder of the year.

Economic Outlook

Any economic forecast is a combination of fundamental factors that define the longer-run growth trend and a series of short-run developments that generate cycles around that trend. It is the unfortunate lot of the economic forecaster that more is generally understood about the determinants of the long-term trend than is known about the effect and timing of the short-term factors.

The current outlook for the economy is a case in point. Was the first quarter's abrupt deceleration from the rapid growth over the second half of last year an aberration triggered by the erosion of post-election euphoria and incredibly bad weather, or the first step toward economic oblivion? The forecast presented here is based on the former assumption. Economic growth is anticipated to accelerate modestly throughout this year and into early 1994, before slowing again in mid-1994 as the impact of the proposed deficit reduction is felt. The longer-run outlook is for a continuation of the slow-growth re-tooling mode of the last four years.

Long-Run Structural Change: Since 1989, the economy has been adjusting to a series of structural changes -- the aging of the baby boom, the unification of Europe, the collapse of the Soviet Union, the computerization of American industry, the modification of inventory practices, the restructuring of the banking and thrift industries, and a change in the fundamental direction of fiscal policy are to name but a few. It is a tribute to the basic resiliency of the American economy that it has been able to weather this sea change with only a brief war-induced recession. The evolution has not been painless. Growth over this period has been an imperceptible 0.9 percent. Even if one excludes the brief recession of 1990-1991, the growth rate has been only 2.0 percent -- about the economy's long run potential and well below the 3.7 percent average over the 1982-1989 period. As a result, job growth, income growth, and confidence have taken a beating. While some of these structural changes are largely completed, others likely will continue for much of the decade, maintaining their drag on economic growth.

Short-Run Outlook: As shown in the accompanying table, the current short-term forecast calls for a modest improvement in economic growth over the remainder of this year and early 1993. This growth is predicated on consumption growth slightly above its 1992 pace, a resurgence in residential construction, and a continuation of strong investment in equipment. Unfortunately, one of the engines of growth over the last few years, net exports, has turned negative and is expected to remain a drag over the forecast horizon.

With the growth in real GDP projected to be at, or only slightly above, the economy's long-run potential, there will be only modest improvement in the unemployment rate. The unemployment rate is expected to bottom out in early 1994 at about 6.8 percent, before rising again as the economy struggles with deficit reduction. The slack in the labor market, however, should be a plus for inflation.

Despite recent increases, inflation is not expected to be a factor in the forecast. The increases in both consumer and producer prices over the first quarter were largely the result of transitory factors such as bottlenecks in the lumber markets and weather related shortages. The weakness in the labor markets and the continued excess plant capacity should prevent any sustainable price increases.

The general weakness in the economy and the lack of inflation should keep interest rates fluctuating in their current range. Short-term interest rates, which are in large part determined by monetary policy, are expected to rise slightly toward year-end as the economy improves. With inflationary expectations under control, however, long-term interest rates should hold steady, perpetuating the historically steep yield curve.

Growth Factors: Representing over two-thirds of the domestic economy, consumption is the key to the forecast. The weakness in consumption over the last few years has been attributed to flagging income growth, the need to restructure debt levels in the wake of the borrowing binge of the 1980s, and a lack of confidence in the employment outlook. Recent data suggest that the economy has made sufficient headway on these fronts to warrant a modest pickup in consumption.

Job growth of late has been modest but sustainable, and consumer confidence, though fickle, appears to have stabilized. The household debt picture has improved as well. Although debt to income ratios have not fallen much from their peaks of a few years ago, servicing costs have fallen sharply as consumers have restructured their installment credit and refinanced their mortgages to take advantage of lower interest rates.

Housing construction is also expected to boost economic activity this year. Although population demographics no longer support annual housing starts in the 2 million unit range, most forecasters estimate the long-term need for new and replacement housing at about 1.4 million units annually. Housing construction has been running well below this level since 1989, creating a pent-up demand. The current combination of low mortgage rates and modest housing price increases lack only the confidence factor to unleash this demand.

The final supporting character in this growth outlook is investment in business equipment. After shrinking in 1990 and 1991, investment in equipment expanded smartly last year and is expected to mirror that performance this year. Recent

studies suggest that the productivity boost from computerization is much greater than originally measured, and business are taking every opportunity to augment productivity by automating the workplace.

Weaknesses: The aforementioned factors should be strong enough to offset a continuing slowdown in government purchases, stagnant investment in structures and a declining net export sector. Of these weaknesses, the foreign sector is the most problematic. Although domestic growth is projected to be slow in absolute terms, it is expected to outpace that of Europe and Japan. Thus, export demand is projected to continue to deteriorate. Recent efforts by the Japanese, and to a lesser extent the Germans, to boost their economies are likely to have little effect before mid- or late-1994.

Risks to the Forecast: As is often the case, the major risks to the forecast are policy induced. In this instance, the more likely culprit is fiscal policy, or rather the lack thereof. Should the deficit reduction hopes of the economy be gridlocked in the halls of Congress, the recent declines in long-term interest rates would prove short lived. The ensuing rise in rates likely would shatter the fragile confidence level and trigger a retrenchment in consumption and investment. On the other hand, if the current fiscal program were adopted, but proved inadequate at reducing the deficit, the same sort of crisis of confidence could materialize. However, in the latter case, the recognition, and subsequent downturn, would come at a later date.

Policy Outlook: Monetary policy is expected to be relatively benign over the forecast horizon. As the only real policy game in town, the Federal Reserve must walk a tightrope between its inflation fighting image and the need to keep the economy growing. While this is nothing new for the Fed, the stakes may be somewhat higher than normal. The Democratic Congress, especially certain factions in the House, have renewed their attempts to reign in the independence of the Fed. A policy mistake erring in the direction of excessive tightness would embolden this anti-Fed faction. On the other hand, any sign of wavering in its inflation fighting resolve would trigger a negative reaction from the financial markets and a rise in long-term interest rates.

Fiscal policy is still very much in flux. As originally proposed, the Administration's plan had three components: a short-term fiscal stimulus; a mid-term deficit-neutral infrastructure shift; and, a longer-term deficit reduction program based more on spending cuts rather than tax increases. The plan was expected to modestly improve the growth projection for late-1993 and early-1994, and to have a relatively neutral impact until mid-1995. Recent developments have changed that outlook somewhat.

The failure of the fiscal stimulus package --a casualty of a Senate filibuster -- and the slower than anticipated growth in the first quarter mean that the tax increases designed to reduce the deficit must be imposed on a more fragile economy. The economy's ability to withstand this burden, while maintaining growth sufficient to generate new jobs, is suspect. Moreover, the weaker growth will produce a higher deficit than anticipated.

Proposal Goes to the Senate

The House passed the Administration's economic package on a narrow vote. Although they kept the overall structure with the increase in individual tax rates and the proposed energy tax, they made the following changes:

- The increase in the corporate tax rate was reduced by half, from 36 percent to 35 percent;
- The expensing limit under Section 179 was increased to $25,000 from $10,000;
- The proposal to treat all royalty income as passive was deleted;
- A provision to repeal the luxury tax on airplanes, boats, furs and jewelry and to index the luxury tax threshold on automobiles was added; and,
- Both the temporary incremental investment tax credit (ITC) and the small business ITC were stripped.

The Committee also retained the extension of the expiring tax provisions, such as the R&E and targeted jobs tax credits and the employer-provided educational assistance exclusion, and provisions to modify the alternative minimum tax depreciation schedule and to eliminate the depreciation calculation required in computing the adjusted current earnings adjustment (both provisions would become effective January 1, 1994). The Committee made no provision for relief for Subchapter S taxpayers or partners from the increased individual tax rates.

While these changes will have a substantial impact on specific industries and corporations, the anticipated macro-economic effects should be relatively mild. Moreover, the bill narrowly passed the House and promises to be altered further in the Senate where opposition to the BTU tax is even stronger.

A3840-6

ECONOMIC OUTLOOK

Chamber of Commerce of the United States | Third Quarter 1993

Recovery Still Seeks Firm Foothold

The long season of uncertainty continues for the U.S. economy as the struggle to recover from the 1990-91 recession drags into 1993's second half. The recovery has been subdued and choppy, with periods of surprising strength followed by intervals of abysmal growth. Overall, growth has run at an anemic 2.4 percent since the recovery began in March 1991. Because it's been fighting against several long-term structural adjustments, such as less military spending and greater global trade, the recovery has not made much headway.

The economic outlook presented here suggests that this feebleness persists through at least 1994. Annual growth over the next six quarters is expected to average 2.4 percent, a full percentage point below the average growth rate registered during the 1980s expansion. Despite sharply lower long-term interest rates, structural changes continue to dominate the economy's performance. After taking a reading of the economy's recent progress, the structural changes and Federal Reserve policy will be discussed in greater detail.

1993: A Frustrating First Half

It appeared that the final months of 1992 would signal the end of this period of low growth. But after growing 4.6 percent in 1992's second half (and an astounding 5.7 percent in the fourth quarter), the economy has only managed a meager 1.3 percent gain in the first half of 1993. Households, who had spent freely during the 1992 Christmas season, tightened their belts so much that consumer spending rose only 0.8 percent in the first three months of 1993. That led to a build-up of inventories -- $9 billion in autos alone -- and exports and defense spending contracted sharply during the first quarter. The next three months saw some improvement -- exports rebounded, new car purchases climbed, and overall consumption rose -- and growth improved from 0.8 percent in the first quarter to a still meek 1.9 percent in the second quarter.

Enthusiasm remains low, since job growth has been so sluggish -- only 1.8 million new jobs were created in the twelve months ending in September 1993, compared to a 2.7 million annual pace during the 1980's expansion -- and the threat of layoffs continues to haunt American households. Meanwhile, the slow economic growth plaguing the other Western economies is limiting our exports. A major engine of growth during the late 1980s, exports have been growing at a significantly slower rate over the past couple of years. The trade deficit, which averaged $19 billion in 1991, will mushroom to a projected $76 billion in 1993.

With so many limiting factors, it's difficult to see how economic growth in the next six months could even match the 3.6 percent average growth rate of the 1980s expansion. Instead, the pervasive weakness will keep the economy in the doldrums. We project that GDP growth in the third quarter will come in at 2.3 percent and then improve to 2.6 percent in the fourth quarter.

Consumer spending, which makes up two-thirds of the total economy, is expected to continue expanding above 3 percent in 1993's second half. But consumers will shift to a lower gear in 1994 as the job market remains troubled and income gains remain anemic. Consumption is projected to rise only about 2.2 percent in the first half of 1994, a full point below the projected rate for the last half of 1993. This will push overall economic growth down in the first quarter of 1994 to 2.3 percent.

Low growth will continue despite the dramatic fall in long-term interest rates. The yield on 30-year Treasury bonds averaged 6.9 percent in the spring of 1993, down a full point from its level a year before. But even that was improved upon: By mid-October 1993, another point had been shaved off, leaving this bellwether yield averaging just below 6 percent for the month.

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Dr. Martin A. Regalia, Vice President and Chief Economist
Mr. Robert D. Barr, Deputy Chief Economist
Ms. Susan C. Hammann, Associate Manager
Ms. Liesl A. Massaro, Economic Policy Assistant

U.S. Chamber of Commerce

Economic Forecast: Third Quarter 1993

	93.1	93.2	93.3	93.4	94.1	94.2	94.3	1991	1992	1993	1994
Gross Domestic Product											
Percent Change											
Nominal GDP	4.4	4.3	4.8	5.9	5.0	5.0	4.8	3.2	5.5	5.5	5.1
Real GDP	0.8	1.9	2.3	2.6	2.3	2.5	2.2	−0.7	2.6	2.7	2.4
Consumption	0.8	3.4	3.4	3.2	2.1	2.4	2.2	−0.4	2.6	3.1	2.6
Residential Investment	1.5	−9.5	7.2	6.2	4.1	−0.3	−0.9	−12.8	16.3	6.6	2.4
Business Investment	14.4	16.6	6.4	4.8	4.9	4.5	4.6	−5.9	2.9	10.6	5.6
Equipment	19.9	19.8	8.1	7.0	6.1	5.6	5.8	−3.4	6.8	14.8	7.1
Structures	0.5	8.1	1.8	−1.3	1.5	1.1	1.2	−10.8	−6.0	−0.0	1.3
Exports	−2.4	3.6	3.0	3.2	5.2	4.6	3.9	6.4	6.4	3.0	4.2
Imports	11.6	13.3	7.3	6.1	4.4	3.9	3.3	−0.5	8.7	9.8	5.4
Government Purchases	−6.4	4.3	−0.2	−0.5	0.6	1.1	0.8	1.5	−0.1	−0.8	0.6
Federal	−16.2	2.0	−3.1	−4.5	−3.9	−2.5	−2.0	0.6	−3.5	−4.4	−2.9
State & Local	0.3	5.6	1.6	2.0	3.4	3.2	2.4	2.0	2.2	1.6	2.6
Final Sales	−0.8	3.2	2.7	2.5	2.3	2.4	2.1	−0.4	2.3	2.5	2.4
Billions of 1987 $											
Change in Inventories	29.3	13.0	8.1	9.8	10.2	11.5	12.6	−8.4	6.5	15.1	13.1
Net Exports	−59.9	−75.2	−82.6	−88.0	−87.8	−87.6	−87.4	−19.1	−33.6	−76.4	−87.7
Major Economic Indicators											
Percent											
Unemployment Rate	7.0	7.0	6.8	6.7	6.6	6.6	6.6	6.8	7.4	6.9	6.6
Percent Change											
Employment Growth	1.2	2.1	2.5	1.7	1.3	1.0	1.1	−0.9	0.6	1.5	1.5
Industrial Production	5.7	1.8	3.2	2.4	3.6	3.0	2.8	−1.8	2.3	3.9	2.9
Compensation	3.2	1.6	3.7	3.6	3.9	3.6	3.7	4.8	3.6	3.1	3.6
Productivity	−1.6	−2.5	1.4	1.3	1.1	1.7	1.4	0.3	2.7	0.4	1.1
Unit Labor Costs	4.8	4.2	2.3	2.3	2.7	1.8	2.3	4.6	0.9	2.7	2.4
Consumer Price Index	3.8	2.9	2.0	3.2	3.1	3.0	3.0	4.2	3.0	3.1	2.9
Implicit GDP Deflator	3.6	2.3	2.5	3.2	2.7	2.5	2.5	3.9	2.9	2.8	2.7
Millions of Units											
New Car Sales	8.3	9.0	8.8	8.9	9.0	9.0	9.0	8.4	8.4	8.8	9.0
Domestic	6.3	6.9	6.7	6.8	6.8	6.8	6.8	6.1	6.3	6.7	6.8
Thousands of Units											
Housing Starts	1,158	1,233	1,286	1,274	1,289	1,264	1,265	1,011	1,208	1,238	1,274
Percent											
Prime Interest Rate	6.0	6.0	6.0	6.0	6.0	6.0	6.0	8.5	6.3	6.0	6.0
Federal Funds Rate	3.0	3.0	3.0	3.1	3.1	3.1	3.1	5.7	3.5	3.0	3.1
3−Month Treasury Bill	3.0	3.0	3.0	3.1	3.1	3.1	3.1	5.4	3.4	3.0	3.1
30−Year Treasury Bond	7.1	6.9	6.3	6.0	6.0	5.9	5.9	8.1	7.7	6.6	5.9
Corporate Bond Rate	7.7	7.4	6.8	6.7	6.6	6.5	6.5	8.8	8.1	7.2	6.5
30−Year Fixed Mortgages	7.7	7.5	6.9	6.7	6.6	6.6	6.6	9.2	8.4	7.2	6.6
Percent Change											
Real Pers. Disp. Income	−7.7	5.8	1.1	2.4	0.7	0.4	3.2	0.1	2.9	1.6	1.7
Corporate Profits	−6.5	26.2	19.3	2.6	4.8	6.8	2.9	−2.9	10.2	13.6	7.4

Figures shown at seasonally adjusted, annual rates. Corporate profits shown with inventory valuation and capital consumption allowances.

What's Pushing Interest Rates Down. . .

Three forces have pushed long-term interest rates down so sharply. First, there's the prospect of significantly reduced federal budget deficits. Less government borrowing means less demand for loanable funds and, consequently, lower interest rates. Since just after the presidential election, when the Clinton camp named such known deficit hawks as Lloyd Bentsen, Leon Panetta, and Alice Rivlin to top economic-policy posts, the chances that the deficit would be shrinking began to improve -- and long-term interest rates began to fall. Of course, these rates rose somewhat during the fall campaign as the market digested the idea of a Democratic president being coupled with a Democratic Congress. But the market's worries were assuaged by the anti-deficit credentials of the economic team. Their work led to the August passage of the federal budget (Omnibus Budget Reconciliation Act of 1993), which, according to the Congressional Budget Office, will lower the deficit by $433 billion over the next five years.

Second, long-term interest rates have fallen because inflation has remained so well behaved. For the four-year period ending in 1994, the Consumer Price Index will average 3.0 percent, the lowest four-year period since 1964-67. That means that the current period of low inflation even beats the mid-1980s, when oil prices collapsed. With evidence like this and the continued commitment by the Federal Reserve to low inflation, the bond markets are lowering their expectations of future inflation, a critical component of long-term interest rates. In fact, after taking into account the going level of inflation, long-term rates are still above their historical norm. This implies that there's room for these rates to fall further.

Third, slow economic growth has lowered the demand for loanable funds, which, just like the lessened federal borrowing, allows interest rates to fall. The depression in commercial real estate has led developers (those that remain) to scale back the few projects that still have the go-ahead. Other businesses have been slow to expand, and so corporate loan demand has tumbled.

These three forces behind the decline in interest rates cannot claim equal credit. After a decade of deficit-cutting packages, OBRA '93 is certainly treated with a great deal of skepticism. While the CBO's $433 billion estimate of the deficit reduction is 86 percent of the Administration's claimed $498 billion five-year total, a survey of business economists projects a reduction that's only a quarter of the Administration's total. Certainly such low expectations for real deficit-cutting couldn't have led the bond market to push long-term interest rates down by two full percentage points. It's tough to sort out the separate effects, but it's likely that the lion's share of the drop in rates is due to a retrenchment in expectations of future inflation. The weak economy is also playing a strong supporting role in lowering long-term rates. This means that the inflation outlook is the key to the path of interest rates.

. . . And Why Lower Rates Aren't More Potent

But while low long-term interest rates give way to still lower rates, the economy seems largely disinterested. Business confidence is flagging, according to surveys conducted by the Conference Board. Another survey reports that capital investment spending in the fourth quarter will be only 2 percent above 1992's fourth-quarter level; the year-over-year change for the third quarter was 11 percent.

Meanwhile, housing starts were sluggish through the first seven months of 1993, averaging 1.20 million units -- practically the same as 1992's 1.21 million-unit rate -- though there's a month's worth of evidence that housing may be gearing up. Powered by a surge in single-family construction, housing starts in August reached an annual rate of 1.32 million units, the fastest pace recorded since the recovery began. This may be the start of an upswing, or just a short-lived building blitz. Given the dourness of other economic sectors, we suspect that housing starts will average 1.29 million units in the third quarter of 1993 before dropping back to 1.27 million units in the year's final quarter. This rickety improvement is apparent in the other national housing statistics. Despite the lowest mortgage rates in more than a generation, sales of existing homes retreated in August, after advancing for the five prior months. New home sales, meanwhile, fell 3.1 percent in August after falling 1.7 percent in July.

That's because American households are still spooked by the massive number of layoffs that have been announced by so many major U.S. corporations over the past few years. The need to cut costs runs so deep that most of those who lost their jobs wouldn't be rehired by their former employers even if the economic growth were robust. And manufacturing firms, where rehiring might be expected to be found, have continued to trim their payrolls. U.S. factories have shed a quarter of a million jobs in the past twelve months. Additionally, rising nonwage labor costs, that is, fringe benefits such as health insurance, and the uncertainty over health care reform are probably lessening firms' willingness to hire additional workers.

One bright spot in the outlook is business spending on equipment. While its growth rate over the next year will be only half of the 20 percent annual rate seen in the first half of 1993, it will still be relatively strong. The attempt to save on labor costs has meant more investment in computers and related technology. While it causes displacement today, the substitution of capital for labor is a crucial element of increasing productivity, and it's higher productivity that ultimately generates higher standards of living. Count on business investment to contribute significantly to overall growth in the coming year.

Structural Changes To Aid Long-Term Health

The recovery never got off to a good start. The typical post-World War II recovery has experienced 5.2 percent growth in the first four quarters following a recession's end; the current recovery grew at a paltry 1.7 percent rate over the corresponding period. That's probably because the recession and its resulting recovery were never part of a typical boom-bust cycle but were more related to a debt-deflation recession, characterized by deteriorating real estate prices and debt consolidation.

Looking over a longer period, economic growth has exceeded the 3.6 percent average growth rate of the 1980's expansion in only three of the 22 quarters since the beginning of 1988. While negative growth rates were recorded for only nine months of that time, that's over five years of economic mediocrity.

What has made the economy so lethargic? Many forces have been at play -- the credit crunch, increasing regulation, even yuppie angst over the profligacy of the Eighties. Underlying these forces are profound structural shifts -- changes in the economic environment that are affecting firms, workers, and policymakers. These changes include: less defense spending, debt reduction, greater international trade, the meltdown of commercial real estate construction, sharply lower levels of inflation, and advances in technology, particularly in information processing.

All of these changes have required adjustments, sometimes severe, for those involved, and these dislocations have made the structural shifts unwelcomed in many quarters. Less money spent on defense means that resources can be channeled elsewhere -- but the struggling communities next to shuttered military bases demonstrate that the transition isn't easy. A study by the Federal Reserve Bank of New York tallied 855,000 lost jobs related to the defense build-down in the years 1987-92. Meanwhile, office automation has pruned the number of secretaries necessary to keep a corporation running, and now it's whittling away at the middle managers who used to collect and process information. In just a dozen years, the personal computer has gone from toy to tool. But instead of despairing of technology that replaces jobs, we need to understand that as the economy evolves, both opportunities and dinosaurs will be created. Adapting to the new technology now paves the road to high productivity and, as a result, a higher standard of living later.

The Fed's Fight Against Inflation

These structural shifts are Exhibit A in explaining the slowdown in the economy since 1988. Exhibit B is the Federal Reserve's inflation-fighting monetary policy. In an attempt to achieve effective price stability, the Fed squeezed credit in 1987-88, putting upward pressure on short-term interest rates. They consequently climbed over two percentage points, and, by 1989, almost caught up with long-term rates, which had remained fairly level. This type of policy is usually followed by either a recession or a period of severe slowdown, and that's just what happened. But the Fed's goal of achieving a "soft landing" -- slowing the economy down enough to stem inflation without sliding into a recession -- was dashed by the sharp rise in oil prices that followed Iraq's invasion of Kuwait in August 1990.

Although the Fed has eased monetary policy since then -- short-term rates have fallen dramatically -- it still keeps a wary eye on the inflation rate. Its target remains price stability (commonly defined as inflation at no more than 2 percent), and the Fed's commitment to achieving it must be one of the foremost assumptions underlying any projection of U.S. economic growth.

As mentioned above, getting used to lower inflation is itself one of the structural changes with which the economy is grappling. The falling inflation rate seen during the 1980s means that consumers can expect smaller price increases at the grocery store. But it also means a smaller increase in their paychecks, a smaller rate of housing appreciation, and a lower rate of interest paid on the their bank CDs. Social Security benefits will rise 2.6 percent in 1994, the second smallest rise since payments were automatically indexed to the change in consumer prices in 1975. Businesses, meanwhile, realize that they can't pass on increases in costs as easily to consumers, giving firms increased incentive to improve productivity. As households and firms consider their future plans, inflationary expectations have to change.

That's why the inflation scare during the spring of 1993 -- when several of the monthly inflation reports showed unexpectedly high increases -- led many analysts to believe that the Fed would nudge short-term interest rates higher, even as sluggish as the economy was. As it turned out, the Fed's policymakers did in fact adopt a bias toward tightening during their May 1993 meeting. This was a step short of actually tightening, but it showed that the gun had been cocked and that the Fed's finger was on the trigger. Perhaps just the threat of higher short-term rates was enough to calm incipient fears of a new bout of inflation, since the monthly numbers subsequently softened, with the Producer Price Index recording four consecutive declines in the months May through August. By summer's end the Fed's bias toward raising rates had been removed, and the central bank reverted to the "wait and see" neutral stance that has left short-term rates at their current levels.

The Fed isn't likely to allow short-term interest rates to fall any further without compelling evidence that either the inflation rate is on a significantly lower track or that the economy has deteriorated so much that it's contracting. Since neither looks imminent, Federal Reserve policy will hold fast through, we expect, at least the spring of 1994.